

Are higher taxes taking a bite out of your trusts?



When higher income tax rates and a new, additional tax on net investment income (NIIT) went into effect a few years ago for higher-income taxpayers, most of the focus was on individual taxpayers. But the impact of higher taxes on trusts shouldn't be overlooked. The income thresholds for trusts are extremely low, so it's important for taxpayers at all income levels to consider the potential impact on their estate plans.

TOP RATES

For 2016, the top marginal individual income tax rate is 39.6%. And the long-term capital gains rate for taxpayers in the highest bracket is 20%. Higher-income taxpayers are also now subject to the 3.8% NIIT on net investment income — including interest, dividends, annuities, rents, royalties, net capital gains and certain passive business income. The income levels at which these tax increases apply vary. (See the "Overview of 2016 Tax Thresholds" chart on the next page.)

This year, trusts are subject to the 39.6% ordinary-income rate and the 20% capital gains rate to the extent their taxable income exceeds \$12,400. And the 3.8% NIIT applies to undistributed net investment income to the extent that a trust's adjusted gross income exceeds \$12,400.

3 WAYS TO SOFTEN THE BLOW

Three strategies can help you soften the blow of higher taxes on trust income:

1. Use grantor trusts

An intentionally defective grantor trust (IDGT) is designed so that you, the grantor, are treated as the trust's owner for income tax purposes — even though your contributions to the trust are considered "completed gifts" for gift and estate tax purposes. IDGTs offer significant advantages. The trust's income is taxed to you, so the trust itself avoids taxation. This allows trust assets to grow tax-free, leaving more for your beneficiaries. And it reduces the size of your estate. Further, as the owner, you can sell assets to the trust or engage in other transactions without tax consequences.

Keep in mind that, if your personal income exceeds the applicable thresholds, using an IDGT won't avoid the tax increases described above. Still, the other benefits of these trusts make them very attractive.

2. Change your investment strategy

Despite the advantages of grantor trusts, nongrantor trusts are sometimes desirable or necessary. At some point, for example, you may decide to convert a grantor trust to a nongrantor trust to relieve yourself of the burden of paying the trust's taxes. Also, grantor trusts become nongrantor trusts after the grantor's death.

One strategy for easing the tax burden on nongrantor trusts is for the trustee to shift investments into tax-exempt or tax-deferred investments.

3. Distribute income

Generally, nongrantor trusts are subject to tax only to the extent they accumulate taxable income. When a trust makes distributions to a beneficiary, it passes along ordinary income (and, in some cases, capital gains) that is taxed at the beneficiary's marginal rate. Thus, one strategy for minimizing taxes is to distribute trust income to beneficiaries in lower tax brackets. The trustee might also consider distributing appreciated assets, rather than cash, to take advantage of a beneficiary's lower capital gains rate.

Of course, this strategy may conflict with a trust's purposes, such as providing incentives to beneficiaries, preserving assets for future generations and shielding assets from beneficiaries' creditors.

The impact of higher taxes on trusts shouldn't be overlooked.



OVERVIEW OF 2016 TAX THRESHOLDS

	39.6% ordinary-income tax rate and 20% long-term capital gains rate	3.8% net investment income tax
FILING STATUS	TAXABLE INCOME OVER:	MAGI* OVER:
Single	\$415,050	\$200,000
Head of household	\$441,000	\$200,000
Married filing jointly	\$466,950	\$250,000
Married filing separately	\$233,475	\$125,000
Trust	\$12,400	\$12,400

*MAGI is modified adjusted gross income, which is adjusted gross income (AGI) plus any excluded foreign earned income.

A HELPFUL REVIEW

Ask your tax or estate planning advisor for help reviewing your estate plan. Doing so may very well reveal opportunities to reduce your family’s tax burden.

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